EUR & ECB crib sheet: Forced patience leaves the euro vulnerable

We expect the European Central Bank to retain maximum flexibility at its March meeting. While this is a largely priced-in scenario, it would leave the euro vulnerable to the adverse exposure to the conflict in Ukraine and high energy prices. In our crib sheet, we look at four different scenarios, along with the potential impact on EUR/USD and 10Y Bund yields

Caution should prevail given external uncertainty

Only a few weeks ago, a hawkish shift by the ECB at the March meeting appeared almost certain, and this notion had boosted some idiosyncratic EUR strength as markets gambled heavily on the start of the tightening cycle this summer. The conflict in Ukraine – and the consequences for energy prices – have clouded the economic outlook for the eurozone, and materially increased the probability that the ECB will strike a more cautious tone than previously anticipated.

We discuss our expectations for Thursday in our March ECB preview. In a nutshell, we expect the Governing Council to retain maximum flexibility given the high uncertainty around the economic impact of the Russia-Ukraine conflict. This implies that the Bank will not signal a specific end date to asset purchases, and will adopt a more gradual approach to tapering (e.g. announcing EUR 5-10bn per month reductions in net asset purchases under the Asset Purchase Programme).

Scenario analysis: How to position for Lagarde's alternatives

	Inflation outlook	Growth outlook	Interest rates	QE and PEPP	EUR/USD	10Y Bund
Current stance	"Inflation persistent, but should settle below 2% in the projection horizon"	"Expecting recovery to continue, driven by robust demand"	Depo at -0.50%. No hikes before 2023.	PEPP to end in March. APP gradually scaled back, €20bn p.m. from October		
Dovish	Inflation to correct in 2022, set to trend below target in the projection horizon.	Energy prices and Ukraine war increase the risk of stagflation	No hikes in 2022. First hike shortly after end of APP	No further tapering discussion, APP may be extended into 2023.	1.08	-0.10%
ING Base Case (neutral)	Higher **vigilance** on inflation, but **core to ease from early 2023 onwards.**	Recovery sustained, but **high energy prices pose risks** to the outlook	**Door still open to hike in 2022. First hike shortly after end of APP**	**Net purchases will be reduced by €5-10bn p.m. starting in May.**	1.09	0.10%
Hawkish	Risks to inflation over the medium term tilted to upside	Recovery sustained, limited downside risks from high energy prices	Even if rate guidance remains unchanged, implicit hints at a 2022 hike	GC actively discussing the end of APP	1.10	0.15%
Very hawkish	Inflation seen persistently above target in the projection period.	Strong recovery, negligible downside risks	First rate hike likely by the end of 2022	Announcement that APP will end in 3Q22	1.11	0.25%

Source: ING

The EUR should remain vulnerable

The euro, like most other European currencies, has been negatively affected by the geographical and commodity-related exposure to the Russia-Ukraine conflict. We struggle to see a near-term recovery in EUR/USD in the current market environment.

When it comes to the ECB impact, we think markets have already priced in a cautious tone by President Christine Lagarde this week, and we do not expect a material negative impact on the EUR after the policy announcement.

It will be interesting to see whether the ECB once again talks about "monitoring" the exchange rate, which it has not mentioned in recent statements. We doubt this could have a tangible impact on the euro on Thursday, but it could introduce the notion that the ECB may consider measures to support the currency should it fall further, in an attempt to mitigate the drag generated by high energy prices.

In the near term, geopolitics and commodity swings are set to remain the main driver for EUR/USD and any post-ECB impact may be quickly overshadowed. Russia's threat to stop the gas supply to Europe is currently adding to the downside risks that the euro is facing due to its proximity to the conflict and already elevated commodity prices.

EUR/USD is not screamingly undervalued at the moment (around 0.5% according to our short-term fair-value model), as its drop has been largely warranted by the US-eurozone divergence in short-term rates and equity performance (in the last month: S&P500 is off 7%, Eurostoxx 50 is off 15%), as well as worsening risk sentiment.

> This means that there is more room for markets to price in a risk premium linked to a supply shock in energy markets in the eurozone, and a move to the 1.0640, 2020 lows, is a possibility in the near term.
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> As discussed in our March FX Talking, we continue to see some moderate upside risks for

EUR/USD in the longer run.

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